IT 96-37
Tax Type: INCOME TAX
Issue: Business/Non-Business (General)

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS

THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS	)	
v.	)	No.
	)	FEIN
TAXPAYER,	)	
Taxpayer	)	

RECOMMENDATION FOR DISPOSITION

Appearances: Diane M. Anderson, of Neal, Gerber & Eisenberg, for the taxpayer; Deborah H. Mayer, Special Assistant Attorney General, for the Department of Revenue.

Synopsis:

This is a case involving TAXPAYER, a Delaware corporation authorized to do business in the State of Illinois. On May 7, 1991, the Department of Revenue issued a Notice of Deficiency to the taxpayer for $525,880 for the tax years ending December 31, 1986 through December 31, 1988, inclusive of applicable penalty under 35 ILCS 5/1005.

The bases of the proposed deficiency are: 1) the disallowance of the carry forward of a 1984 partnership loss to 1986, and 2) not including CORPORATION in the taxpayer's unitary business group since 80% of its business activity is outside the United States.

By its protest, the taxpayer takes the following positions regarding the issues raised in the Notice: 1) that the 1986 gain of PARTNERSHIP (a member of taxpayer's unitary business group) on the sale of STOCK stock must be adjusted

to reflect the 1984 loss incurred by the partnership, and 2) that CORPORATION should be in the taxpayer's unitary business group. Following a hearing on the above described issues, I recommend for the taxpayer, in part, and for the Department, in part.

Findings of Fact:

1. TAXPAYER (taxpayer) filed U.S. forms 1120 for tax years ending 12/31/86 through 12/31/88. (Exhibits E through G). The taxpayer further filed Illinois forms IL-1120 for the same period. (Exhibits H through J). The taxpayer was audited for those tax years. (Exhibit K).

2. The taxpayer owned a 50% general partnership interest in the PARTNERSHIP, an Illinois general partnership formed on June 22, 1984. The purpose of the partnership was to purchase and hold 1,360,000 shares of $3.69 Cumulative Redeemable Preferred Stock in STOCK. (Stip. Nos. 9 & 11).

3. The partnership's initial capitalization was composed of partner's equity of $2,120,000, of which the taxpayer contributed $1,060,000. The partnership also borrowed $45,560,000 from a third party to enable it to acquire and maintain its investment in the preferred stock. (Stip. No. 12).

4. The preferred stock was redeemed by STOCK on August 8, 1986, at a price of $65,497,600 ($48.16 per share) pursuant to a redemption agreement between the parties. (Stip. Nos. 13[c] & 14).

5. Immediately after the redemption, the partnership paid the loan in full. On August 11, 1986, the partnership distributed virtually all of the net proceeds from the redemption to the taxpayer and the other partner. (Stip. No. 15).

6. In 1984, the taxpayer's distributive share of the partnership's expenses was $1,724,388, of which $1,706,602 was interest expense. For Illinois income tax purposes, the taxpayer's distributive share of the expenses from the partnership in 1984 was allocated to Illinois. (The Department of Revenue

determined that the partnership was not unitary with the taxpayer in 1984, pursuant to Notice of Decision dated May 1, 1991). (Stip. Nos. 16 & 17).

7. By such allocation, the taxpayer had a partnership loss from a non-unitary partnership of $1,724,388, and business income apportionable to Illinois of $64,424, for 1984 Illinois income tax purposes. (Stip. No. 18).

8. For Illinois income tax purposes, the taxpayer's distributive share of the income from the partnership in 1986 was allocated to Illinois. (Stip. No. 20).

9. TAXPAYER (taxpayer) owned 90% of the outstanding voting stock of COMPANY. COMPANY owned 80% of the outstanding voting stock of CORPORATION Corporation. CORPORATION owned 100% of the stock of DBHC (DBHC), and CBC. (Stip. No. 21). DBHC owned two hotels located in Puerto Rico. (Stip. No. 26).

10. CORPORATION also owned interests in three other partnerships, the purposes of which were to acquire specified parcels of land in Puerto Rico and to develop residential villas on them. (Stip. Nos. 23-25).

Conclusions of Law:

The immediate question to be resolved here is whether the taxpayer is entitled to carry forward any or all of its 1984 loss to the 1986 tax year and reap an offset, deduction or credit? The Department of Revenue asserts that the 1984 loss cannot be carried forward since the Illinois Income Tax Act did not expressly provide for an Illinois loss which could be carried forward to subsequent taxable years. (Notice of Deficiency; Ex. L; Department's brief; Stip. No. 28). The taxpayer asserts that failure to provide a loss carryforward, offset, deduction or credit results in a tax on capital which is not authorized by the Illinois Income Tax Act. It further asserts that such failure is violative of the Due Process, Equal Protection and/or Uniformity Clauses of the United States and Illinois Constitutions. (Protest; Ex. M; Taxpayer's Brief; Stip. No. 28).

The Department has previously determined that the PARTNERSHIP was not unitary with TAXPAYER in 1984. (Stip. No. 17). The distributive share of the partnership income and expenses (net loss of $1,724,388) was allocated to the partnership's commercial domicile, i.e. Illinois. Because this amount was allocated to this State, it was then set off against business income apportioned to Illinois in the amount of $64,424, resulting in a base income allocable to Illinois of $1,659,964. The Illinois Income Tax Act and Regulations defined net income for that period and prohibited a "negative" income carryforward or carryback. 35 **ILCS** 5/202; 86 Ill. Admin. Code, Ch. I, Section 100.2750.

For the years 1982 through 1984, there existed no provision in the Income Tax Act for Illinois net operating losses. Bodine Electric Co. v. Allphin, 81 Ill 2d 502 (1980). In upholding the Department's position, the Court held that the granting of a deduction for net operating losses is a privilege created by statute as a matter of legislative grace. In those years, losses were considered for Illinois purposes only insofar as they were treated as an adjustment to federal taxable income in the years to which they were carried. Specifically the court stated:

> These provisions clearly evidence the legislature's intent that a net operating loss deduction is relevant to the computation of Illinois tax liability only insofar as this deduction enters into the computation of base income under the relevant provisions of the Act. 81 Ill. 2d at 510.

It was only through the enactment of 35 **ILCS** 5/207 that an Illinois net operating loss was provided for, effective for tax years beginning on or after December 31, 1986. Therefore, in accord with Bodine, the losses must be treated as an adjustment to federal taxable income in the years to which they were carried, prior to apportionment. Prvt. Ltr. Ruls. IT-87-030, issued 2/18/87; IT-87-82, issued 4/9/87. Even when Illinois subtraction modifications to a positive federal taxable income resulted in negative Illinois base income, carryforward or carryback of this negative amount was not permitted because there was no provision in the Illinois Income Tax Act for it. Prvt. Ltr. Rul. IT-82-446, issued 4/2/82.

The taxpayer invested in a partnership whose domicile was Illinois. This partnership was subject to the income tax laws governing the taxation of partnerships, including its allocation as non-unitary income. The taxpayer is subject to the laws of apportionment of business income and treatment of net operating losses. Having chosen these forms of organization and the taxing jurisdiction of Illinois, the taxpayer must abide by the legal (i.e. tax) consequences of the choices made.

TAXPAYER argues that the partnership's investment in preferred stock was intended as a two-year "in and out" transaction with a built-in profit[1]; that the borrowing and ultimate gain were this single integrated transaction; that the use of borrowed funds, which generated the loss in 1984, was integral to the economics of the entire transaction. (Taxpayer brief, p. 3). The Department of Revenue, by supposedly overstating the true amount of the taxpayer's income from the partnership, is taxing a return of capital instead of income. (Taxpayer brief, p. 5). This error, it is posed, should be corrected by reducing the gain in 1986 by the 1984 loss previously disallowed for Illinois Income Tax purposes. (Taxpayer brief, p. 6).

Taxpayer submits that its position is required by 35 **ILCS** 5/201, which authorizes a tax only on "net income", and supports its position citing Continental Illinois National Bank and Trust Co. v. Lenckos, 102 Ill. 2d 210, 464 N.E. 2d 1064 (1984). (Taxpayer brief, p. 7). That case held that the taxpayer could reduce its municipal bond interest income by the amortized premium on those municipal bonds, even though no modification was authorized by the Illinois Income Tax Act. The taxpayer argues, like the court in Continental Bank, *supra*, that an adjustment is required to prevent the taxpayer from being taxed on a return of its capital.

[1]. The built-in gain arose under the terms of the preferred stock: after two years, STOCK had the right to redeem the preferred stock from the partnership. Alternatively, the partnership could force STOCK to buy back the stock or find another purchaser. The minimum price under either alternative was $41.71 per share, while the partnership had paid $33.50 per share. (TAXPAYER. brief, p. 4).

The above arguments fail on several grounds. First, the ruling in Continental Bank must be limited to the facts of that case, which ruled that bond premium is capital. Had the taxpayer included the amortized bond premium in income, they would have been subject to a tax measured by capital, rather than income. The case cannot be expanded beyond the clear and limited conclusion that bond premium is capital. The deduction of other expenses or losses was not discussed since it was not presented to the court. Further, the court cited the State's unreasonable discrimination in its according different treatment to federally exempt bonds and federally taxable bonds. This argument too, is irrelevant since the Department in this case has not attempted to treat this loss carryforward any differently from any other loss carryforward.

The taxpayer claims that the distortion which was corrected in Continental Bank arose from the annual accounting principle, just like this case. I find no foundation for such an averment. The Continental court never discussed a causal relationship between the bond premium amortization issue with the annual accounting period. In fact, it never even discussed the annual accounting period in any context.

Taxpayer further makes the argument in its brief that:

> Continental would not have had any distortion *if* all of its income and expense had been received in the same taxable year. Similarly, all of the '1984 Loss' would have been deductible for Illinois purposes *if* it had been incurred in the same taxable year as the '1986 income'. (Emphasis supplied)

This position is inappropriate. The hypothetical statements attempt to obviate the very foundations of the annual accounting period concept. Simply because a taxpayer incurs an item of expense, does not mean it is entitled to offset that expense against a gain when the expense is incurred and the gain is earned in different tax years. All of the "ifs" did not occur in one year and the taxpayer must accept the consequences of the basic annual accounting period concept.

Related to this concept is the argument regarding the federal tax benefit principle as codified in Internal Revenue Code §111, which states:

> Gross income does not include income attributable to the recovery during the taxable year of any amount deducted in any prior year to the extent such amount did not reduce the amount of tax imposed by this chapter.

The taxpayer cites Smyth v. Sullivan, 227 F. 2d 12 (9th Cir. 1955), aff'g. 53-2 USTC 9514 (N.D. Cal. 1953) as having applied the federal tax benefit rule under facts very similar to taxpayer's. (Taxpayer brief, p. 10). In the cited case, the taxpayer, a decedent's estate, had incurred interest and property taxes on real estate in the years prior to its sale. Those amounts, although deducted in prior years, were treated as an offset to the gain in the year of the sale because there was no tax benefit in the year the expenses were deducted. The taxpayer's position in this matter may indeed be persuasive, but are irrelevant to the case before me. The tax benefit rule is a federal concept which affects the Illinois tax calculation only insofar as it is part of base income pursuant to 35 ILCS 5/203. If the taxpayer had taken the position they are currently asserting with regard to this transaction on their federal return, the Department of Revenue would have been bound by that position (assuming, of course, that it was accepted by the IRS). The taxpayer did not take this position on their federal return and assert it here in order to carry forward an Illinois loss not otherwise authorized.

Further argument is made that in the event an adjustment is not otherwise made, alternative relief is entitled pursuant to 35 ILCS 5/304(f)(4), which authorizes "[t]he employment of any other method to effectuate an equitable allocation and apportionment of the person's business income." (emphasis added). TAXPAYER contends that the Department's literal construction of the Act does not fairly represent the amount of the taxpayer's income from Illinois sources. (Taxpayer brief, p. 11).

The relief provided by section 304(f)(4) is inapplicable to this matter. The issue here is not incorrect apportionment or allocation which is what that section of the Income Tax Act specifically addresses. By agreement of the parties, the non-unitary partnership expense was properly allocated to Illinois

after apportionment to Illinois of unitary income. (Stip. Nos. 17 & 18). Therefore, since the proper issue is whether any portion of the distributive share of expenses properly allocated against properly apportioned business income could be carried forward to another tax year, relief under 304(f) in not available.

The final argument made here is that failure to adjust the gain on sale by the earlier loss violates the Due Process and Equal Protection Clauses of the United States Constitution and the Uniformity Clause of the Illinois Constitution. It is posed that the Rockwood "is being taxed more than any other corporation which received the same *overall* amount of income". (emphasis added) The cause of this disparity stems from the fact that the loss and subsequent gain occurred in two different taxable years while other taxpayers could have their loss and gain occur in the same taxable year. (Taxpayer brief, p. 12).

Taxpayer has answered its own argument. Overall income is not synonymous with annual income. Taxes are based on the annual accounting principle and taxpayers are treated differently only if the timing of their transactions are different. Thus they are not similarly situated and no disparate treatment occurs. Here the fact is that the transactions did not occur in the same year and Uniformity Clause does not require the tax period to be open-ended. To the extent provided by law, the taxpayer received the benefit of the partnership expenses, allocating them to the apportioned income for the unitary group in that year.

The taxpayer cannot carry forward the distributive share of the PARTNERSHIP expense which was allocated to Illinois in 1984 and offset it against the taxpayer's unitary group income in 1986.

The next issue to be dealt with is whether COMPANY and CORPORATION must be excluded from the unitary group pursuant to 35 **ILCS** 5/1501(a)(27), which reads in pertinent part:

> The term 'unitary business group' means a group of persons related through common ownership whose business activities are integrated with, dependent upon and contribute to each other. The group will

> not include those members whose business activity outside the United States is 80% or more of any such member's total business activity; for purposes of this paragraph... business activity within the United States shall be measured by means of the factors ordinarily applicable under subsections (a), (b), (c), and (d) of Section 304 except that, in the case of members ordinarily required to apportion business income by means of the three-factor formula of property, payroll and sales specified in subsection (a) of Section 304, such members shall not use the sales factor in the computation and the results of the property and payroll factor computations shall be divided by 2 (by one if either the property or payroll factor has a denominator of zero).

See also 86 Ill. Admin. Code, Ch. I, Section 100.9900.[2] This is commonly known as the 80/20 rule. A company which would otherwise be a member of a unitary group will be excluded from that group if 80% or more of its business activity is conducted outside the United States.

CORPORATION is a holding company.[3] The Department did not include it in the unitary group, contending that all of its business was in Puerto Rico. (Department brief, p. 13). Relying on generalities and inference,[4] the Department is attempting to use the term "business activity" in a generic sense rather than as specifically defined in the Income Tax Act and departmental regulation. Business activity as prescribed by law, is to be measured by the property *and* payroll factors. (A singular factor is utilized if one has a denominator of zero). The statute, however, does not distinguish between holding and operating companies and provides no alternative method of measuring business activity with respect to corporations having neither property nor payroll as the case here.

Since the 80/20 Rule is one for exclusion from a unitary group rather than a requirement for inclusion, the absence of any other test mandates the application of the general unitary principle, *i.e*. inclusion of CORPORATION in the unitary group. In light of this situation, I expressly agree with the taxpayer's contention that the Department cannot go beyond the statutory

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2. Although not addressed in Taxpayer's brief, DOR regulation 100.9900(c)(2)(A) relates that "...the phrase 'United States' as used in 35 ILCS 5/1501(a)(27) shall include only the fifty states and the District of Columbia.

3. Assumption by both parties supported by the entire record. Department's brief, pp. 13-15; Taxpayer's brief, p. 15.

4. CORPORATION was not included in the unitary group because of taxpayer's own admission that all of its business was in Puerto Rico.

mechanical test and de-unitize an otherwise unitary corporation on the grounds that it is foreign. The Department cannot exclude CORPORATION because it does not meet the statute's mechanical requirements for exclusion. (Taxpayer brief, p. 15).

As a final matter, the penalty imposed by 35 ILCS 5/1005 has to be sustained. The bare statement made that the penalty is inapplicable because reasonable cause existed for the underpayment falls short of establishing facts which prove that reasonable cause, or at the very least overcome the *prima facie* presumption of the correctness of the penalty. Because no such facts have been presented here, the penalty must remain as issued.

On the basis of the above analysis, it is recommended that a Notice and Demand issue incorporating the findings and conclusions made herein.

Harve D. Tucker
Administrative Law Judge